

EXHIBIT 26

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Russia: Official estimates capital flight at \$10-15 million annually

CEP20001220000366 Moscow ITAR-TASS in English 1846 GMT 20 Dec 00

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Capital flight from Russia estimated at 10m-15m dollars annually - official

Text of report in English by Russian news agency ITAR-TASS

Ryazan, 20 December: About 10m-15m dollars obtained illegally are taken out of Russia annually, according to the director of the Federal Tax Police Service, Vyacheslav Soltaganov.

He told journalists on Wednesday [20 December] that his service, in cooperation with the tax service, has prepared draft laws the adoption of which will put an end to **capital flight**.

Speaking of the plans to create tax intelligence - a structure that already exists in 52 countries - in Russia, Soltaganov noted that its creation is in line with the international convention on fighting money laundering which Russia signed last year.

He also stressed that the upcoming reorganization of tax police into financial police was necessitated by the specific nature of its activity which goes beyond control over tax offences.

[Description of Source: Moscow ITAR-TASS -- main government information agency]

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Russian Economic Survey

September 2001

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below), culminating in a surplus of \$61 billion in 2000. With exports at \$52.3 billion and imports at \$24.4 billion, the surplus for the first half of 2001 was \$27.9 billion.

Capital flight continues, although estimates of its scale vary greatly. A consensus of the best Western estimates of cumulative capital flight is around \$150 billion. Much or most of this capital is legal and could rapidly return to Russia once its owners feel that they can trust the government and the banking system. The reasons for the massive scale of capital flight include political instability, loss of confidence in the ruble as a store of value after the high inflation of 1992, the desire to avoid excessive and arbitrary taxes, and the continuing poor protection of property rights. There were indications that the scale of net capital flight in 1999 declined markedly with an influx of capital from Cyprus, Israel, and other havens. The outflow picked up again in 2000, but declined during the first half of 2001.

Russia had been on the priority watch list of the G7's Financial Action Task Force (FATF) as a source of organized financial crime and money laundering. After the Duma passed several anti-money-laundering laws in July, the FATF removed its call for additional countermeasures against Russia, although it has kept Russia on the list of "non-cooperative" countries until the laws are seen to have been implemented.

The Foreign Trade of Russia, 1995-2000

(\$ billions in current prices, incl. shuttle trade)

	1995	1996	1997	1998	1999	2000
Exports	81.1	88.6	88.2	74.2	75.8	105.5
incl. crude & products	17.3	23.1	21.9	14.5	18.8	36.1
incl. natural gas	10.8	15.8	16.4	13.3	11.4	16.6

Imports	60.8	68.8	73.7	59.1	39.7	44.9
incl. machinery & eqpt.	15.8	14.6	18.5	15.6	9.9	10.6

EXHIBIT 28

CAPTURE OF BANKRUPTCY:

THEORY AND EVIDENCE FROM RUSSIA*

Ariane Lambert-Mogiliansky[†], Constantin Sonin[‡] and Ekaterina Zhuravskaya[§]

Abstract

Laws that work well in a country with the rule of law may produce unexpected outcomes in a corrupt environment. We argue that the Russian legal system is impaired by the capture of regional divisions of arbitration courts, and analyze the consequences of this capture. Using a theoretical model and an empirical analysis, we conclude the following: First, governors in alliance with managers of large regional enterprises use bankruptcy to expropriate the federal government and outside investors. And second, the bankruptcy law does not put pressure on managers to restructure; instead, it may even prevent restructuring.

*We are grateful to David Brown for his crucial contribution to the construction of a consistent data base on Russian firms, and Erik Berglof, Rafael LaPorta, Jean Tirole, and Daniel Treisman for helpful comments. We thank Yury Andreyenko and Evgenia Bessonova for excellent research assistance. Financial support from ACE-TACIS Grant No. T95-4115-R and MacArthur Foundation for data purchases is gratefully acknowledged. *Please send comments to: zhuravskaya@yahoo.com*

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"Often, simply with these kinds of bandit methods I defend these enterprises from these things that are called bankruptcy..."; - *Eugeniy Nazdratenko, the governor of Primorsky Kray speaking about the fishing enterprises in the region. "Itogi", p.6, May 4, 1999.*

1 Introduction

The passage of a well-functioning bankruptcy law is an important component of the transition to a market economy. It should protect creditors, impose financial discipline on managers, induce restructuring, and free assets from inefficient use. Russia recently enacted a new bankruptcy law. This paper addresses the question of whether and how the new bankruptcy law and its implementation have changed managerial incentives and increased creditor protection. We argue that a distinguishing feature of the Russian bankruptcy institution is the capture of Arbitrage courts by the regional governments.¹ Arbitrage court judges, who have significant discretion in bankruptcy procedures, are not independent. Based on considerable anecdotal evidence, we observe that regional governors are able to influence the decisions of Arbitrage court judges.²

Governors may benefit from their influence on courts in various ways: they may extract rents from the managers of insolvent firms in exchange for protection from losing control in bankruptcy. Regional authorities may also receive benefits from the managers of profitable enterprises who fake insolvency. The latter use bankruptcy procedures (under regional influence) to avoid federal taxes and debt repayments to creditors outside the region. Governors may also use their influence to prevent the bankruptcy of large enterprises for political reasons. In this paper we focus on the first two cases.

¹The regional divisions of Arbitrage courts hear bankruptcy cases in Russia.

²According to the Russian legislation, all Arbitrage courts are in the federal jurisdiction and, thus, independent from the regional governors. The lack of federal financing and, often, large political and physical distance from the federal center makes Arbitrage courts highly dependent on regional politics: The governors often pay judges' bonuses and provide them with career opportunities.

Based on evidence and a theoretical model, we conclude that the capture of Arbitrage courts results in a failure of the bankruptcy institution to protect creditor rights or to put pressure on managers to restructure.

Russia has had a bankruptcy law since November 1992. The first bankruptcy law was completely ineffective.³ This motivated the adoption of a new law in March 1998.⁴ This law was drafted according to Western standards. In particular, it makes the initiation of bankruptcy proceedings very easy: a three-month-overdue debt of \$5,000 is sufficient for a creditor to file a bankruptcy petition against a firm. This paper analyses the effects of the enactment of the 1998 law.

On the one hand, the law was expected to vastly improve managerial incentives because it is harsh on the incumbent management: under the law, manager lose control in bankruptcy. On the other hand, the law was drafted to avoid inefficient liquidations: judges are given enough discretion sufficient to refuse liquidations suggested by creditors. We show that in the Russian context of weak law enforcement, discretionary powers granted to judges are abused, and the law does not achieve its goals.⁵

Experts had predicted that the law would cause a flood of bankruptcies. Prior to 1998, most Russian firms accumulated large arrears to the government and private creditors. As reported in table 1, the number of bankruptcies has, indeed, increased since the law was adopted. Many economists interpreted this fact as evidence of hardening of managerial budget constraints. Aggregate figures,

³ Between 1992 and 1998, very few companies went bankrupt. A common view is that the failure of this law to bring about financial discipline was due to the limited scope of its application and excessively complicated procedures. To initiate a bankruptcy procedure, the total amount of outstanding debt had to exceed the total book value of a company's assets. To avoid bankruptcy, a company manager could simply issue worthless debt to his own firm at a high face value.

⁴ The second law is currently in force in Russia.

⁵ If a creditor files a bankruptcy petition, the following procedure is undertaken. First, a temporary manager, appointed by an Arbitrage court judge, collects information about the claims on the company and organizes a creditors meeting, where the creditors decide if they want a liquidation or reorganization. Second, the judge, taking into consideration the resolution of the creditors meeting, makes a ruling on the liquidation or reorganization of the company and appoints either a liquidation manager if a liquidation is ordered or an external manager if a reorganization is ordered. The judge does not necessarily need to follow the creditor's request. This clause in the law was motivated by the fact that creditors may opt for an inefficient liquidation. Initiation of either procedure deprives the current management of control over the firm unless a member of the incumbent management team is appointed as an external manager.

however, are insufficient to arrive at such a strong conclusion. By looking at which companies went bankrupt and what happened to companies in bankruptcy, we provide evidence in favor of the opposite conclusion: bankruptcy has softened managers' budget constraints. To explain this, we build a simple theoretical model of capture in bankruptcy and show that empirical evidence is consistent with the model.

The model investigates how bankruptcy capture affects managerial incentives, the financial position of firms and the protection of creditor rights.⁶ A firm with a manager and two creditors is considered. The firm is insolvent in terms of verifiable cash flows but has high private benefits that accrue to the manager. One of the creditors is the governor, who can influence the decisions of the bankruptcy judge. An important assumption of the model is that the governor values bribes from the manager as well as tax debt repayments.⁷ The model shows what happens when the judge is under the governor's influence: debts are not repaid; the firm does not restructure; and the manager pays bribes to the governor in exchange for protection from losing control during bankruptcy. As a result, the outside creditor is expropriated by a coalition of the incumbent manager and the governor. The bankruptcy law not only fails to create additional incentives for restructuring, but it may even prevent restructuring when such incentives exist. The intuition is the following. When official taxes are small, the governor may "stop companies from" or "prevent" restructuring because he can extract bribes only from insolvent firms. When the governor values official taxes highly, restructuring still may not happen because he cannot commit to liquidate; instead, he prefers to accept a bribe from the manager. The model provides a classic example of state capture: the manager captures the bankruptcy procedure via the governor when the governor places a high value on tax income or is weak (i.e., unable to influence

⁶ Aghion, Hart, and Moore [1992] studied the challenges of designing bankruptcy rules in transition economies. In particular, they suggested some measures to overcome liquidity constraints of potential buyers in liquidation.

⁷ Bribes are paid out of manager's private benefit (the shadow income of the firm) and, therefore, are potentially much larger than the official income of the firm, which is the basis for calculating regional taxes.

judges on his own).⁸

We apply this model to the Russian economy by noting that the federal government, which is owed tax arrears by regional enterprises, is in the same position as any outside creditor. We formulate testable hypotheses of the capture model and test them using the data on Russian industrial enterprises. We find that the data are consistent with our hypotheses.

Our empirical results are the following. The probability that an external management procedure is initiated against a particular firm increases with the following regional factors: the strength of the governor in the region, tensions between the governor and the federal center, federal tax arrears in the region, and opacity in the system of regional tax collection. The probability of external management is higher for very large firms in efficient and profitable industries. By contrast, the probability of a liquidation procedure decreases with the strength of the regional governor, tensions between the governor and the center, and federal tax arrears in the region. The probability of liquidation is higher for smaller firms operating in loss-making industries. In addition, we find no evidence that the initiation of external management procedure (imposed by the judge) changes the performance characteristics of firms.

Our results suggest the following. The managers of large enterprises and regional governors collude to expropriate the federal government and investors from outside the region. Large insolvent firms are not restructured. And the incumbent managers stay in control even under the external management procedure. A possible reason is that they are protected by regional governors.⁹

Many authors have argued that "crony capitalism," i.e. maintaining close ties between business and the government in order to restrict competition, obtain favorable finance, and protect insiders

⁸For discussions of state capture see Bardhan and Mookherjee [1999], and Hellman, Jones, and Kaufman [2000].

⁹The name for a reorganization procedure in Russian law is full of irony: in reality "external management" procedure does not result in management change. The procedure would be more appropriately called "incumbent management procedure."

from outside claimants, is a common feature of governance in transition and developing countries. Our paper illustrates that “crony capitalism” increases in Russia as the scale and depth of regional government intervention in the governance of Russian firms increases. There are several interesting papers that make this argument in different contexts: Shleifer and Vishny [1998], Ericson [1999], Treisman [1999], Gaddy and Ickes [1998], and Hellman, et. al. [2000].

Our paper contributes to the literature on federalism in Russia [see, for instance, Shleifer and Treisman, 2000, Treisman, 1997, and Zhuravskaya, 2000] by documenting that the bankruptcy institution is used by regional governments as a mechanism for redistribution of revenue from the federal center to the regions.

The paper is organized as follows. Section 2 presents basic facts about bankruptcies in Russia. Section 3 contains our theoretical model and its empirical predictions. Section 4 presents data, methodology and empirical results. Section 5 concludes.

2 Stylized facts about Russian bankruptcies

In this section, we summarize some basic facts regarding bankruptcy of industrial firms in Russia.¹⁰

1) Before 1998, bankruptcies were extremely rare. After the adoption of the 1998 law, we observe a sharp increase in the number of bankruptcies. In 1998, Arbitrage courts initiated one thousand external management procedures and forty seven hundred liquidation procedures. Table 1 presents aggregate statistics on the initiation of bankruptcy procedures over time.¹¹

2) Liquidation procedures have been initiated in small and rarely medium-size enterprises. External management procedures have been initiated in very large enterprises. Differences in size are large both

¹⁰We derive these facts from the same data set that we use for the systematic empirical tests of our model. This data set is described in section 4.

¹¹Statistics in table 1 are given for all bankruptcies rather than only for industrial enterprises. In the empirical part of our study we focus on industrial enterprises.

in terms of output and employment. The mean output for firms with external management is five times bigger than the mean output for all firms in the registry of Russian industrial enterprises.¹² The mean output for firms that entered liquidation procedures is one third of the mean output for all firms in the registry. The number of employees at externally managed firms is on average four times as large as employment in all Russian firms. The number of employees at liquidated firms is not significantly different from the average in the registry.¹³ Table 2 presents summary statistics for firms subject to external management and liquidation procedures compared to Russia's average.

3) Firms under external management are not inefficient in the technical sense (measured by labor productivity) and many of them have a very high cash flow. There were many industrial firms that did not go into bankruptcy and had worse performance compared to the firms that went into external management. 30.7% of firms had higher costs per ruble of output and 47.7% of firms had lower labor productivity than the median firm where external management was imposed. By contrast, firms under going liquidation are extremely unprofitable and inefficient. The mean labor productivity of firms that entered liquidation was 2.5 times lower and the mean cost per ruble of output was almost twice as large as firms in the registry.

4) Externally managed firms and firms under liquidation are distributed unevenly across industries. Table 3 presents the industrial structure of bankrupt firms. About 80% of externally managed firms' output is produced by firms in three industries: oil and gas (54.5%), chemical (9.4%), and ferrous metallurgy (16.5%). For comparison, the output of all firms in these industries (according to the registry) accounted for 30% of total industrial output. Firms under external management produced 24% of the output in oil and gas industry. Liquidation procedures are most frequent in light, consumer-

¹²The registry is described in section 4. Here and later in this section we compare statistics as of 1996 for firms where bankruptcy procedures were initiated since 1997.

¹³Note that the registry contains a lot of very small enterprises. This drives the average employment down.

oriented industries. Almost half of all liquidation procedures were initiated in logging (21%), wood-working (16%), and textile (7%). 15% of all industrial firms operate in these industries. Industries in which external management procedures are more frequent are the best-performing in terms of cash flows and technical efficiency. On the contrary, industries in which liquidation procedures are more frequent are the worst-performing in terms of cash flows and technical efficiency. Table 4 presents several performance characteristics for these industries.

5) Firms under external management are distributed unevenly across regions as well. 59% of the output of firms under external management was produced in Irkutskaya oblast (11%), Republic of Bashkortostan (13%), Kemerovskaya oblast (16%), and Tyumenskaya oblast (19%). For comparison, the combined output of all industrial firms in these regions amounts to 18% of Russian industrial output. Over 30% of industrial production in Irkutskaya, Kemerovskaya and Tomskaya oblasts is produced by enterprises under external management. 24 regions have less than one percent of their output produced by enterprises under external management.

These stylized facts deserve a short discussion. The political economy literature has supplied a lot of arguments explaining why politicians are generally opposed to the liquidation of large and politically important companies (see, for instance, Shleifer and Vishny [1994]). It is not particularly puzzling, therefore, that only the small and worst firms in poorly performing industries are being liquidated. Most political economy models predict too few liquidations.

The distribution of external management procedures across firms, however, presents a puzzle. External management procedures have been mostly initiated against large and politically important firms in very profitable and efficient industries and/or in politically and economically strong regions. At the same time, firms in many regions and moderately performing industries have been completely unaffected by bankruptcy procedures. Our model of regional political protection provides an explanation

the model in three out of the four tests. Indeed, the hypothesis that there is no difference between growth in labor productivity for the firms that went into external management and for the rest of the firms in their industries cannot be rejected in favor of the alternative, i.e. that it is positive. The difference is statistically indistinguishable from zero. P-values are 0.42, in the case of the "clean test," and 0.78, in the case of the "dirty test". The next hypothesis is that there is no difference between employment growth in the firms that went into external management and the rest of the firms in their industries. The alternative hypothesis is that this difference is negative. The results of this test are mixed. The "clean test" supports our model. The difference is insignificant. P-value for the test is 0.42. The "dirty test" yields a negative difference with t-statistic equal to -1.41 and P-value equal to 0.08.⁴⁸ Since three tests out of the four are consistent with the prediction of our model and only one test rejects it with relatively low power, we conclude that the data broadly support the model of bankruptcy capture. In addition, there are many anecdotes that directly support hypothesis 5.⁴⁹

5 Conclusion

In this paper, we investigate bankruptcy in Russia using a theoretical model and systematic analysis of available evidence. Bankruptcy laws are intended to solve several important problems of governance: release of assets from inefficient uses, secure the rights of creditors, and discipline the managers, etc. Although the Russian bankruptcy law was drafted with these goals in view, in reality it does not induce restructuring or harden managerial budget constraints. We argue that the current legal system in Russia is undermined by the capture of regional divisions of Arbitrage courts. We analyze the

⁴⁸ P-values are given for one-sided tests.

⁴⁹ For example, the team of external managers that are pro-Aman Tuleev (the governor of Kemerovskaya oblast) at the "Kuznetsk Metallurgy Kombinat" performed much worse than their counterparts from a team supported by the major outside investor "MIKOM". Other examples reported in the media include: Achinsky glinozemny kombinat and Krasugol (Krasnoyarski kray), West-Siberian Metallurgy Kombinat (Kemerovskaya oblast), Korshunovsky GOK (Irkutskaya oblast), and GP Russkii Dizel (St. Petersburg).

consequences of this capture.

A supposedly balanced law under the absence of the rule of law has transformed into a mechanism that allows regional governors in alliance with the incumbent managers of the large regional enterprises to leave other claim-holders unsatisfied. In particular, outside creditors, even the major ones, such as large Moscow banks and the federal government, have no effective legal mechanism for collecting their claims.

We build a simple model to investigate some effects of bankruptcy capture. We show that when the judiciary is captured, the manager has no incentive to restructure and the debt to the outside investor is not repaid. Instead, the threat of bankruptcy is used to perpetuate insolvency in a collusive deal between the manager and the governor. We test empirical predictions of the model using data on Russian industrial enterprises. Our empirical results are the following. First, the probability of external management in a firm is positively related to its size, profitability of the industry, strength of the governor in the region where the firm is operating, tension between the governor and the federal center, federal tax arrears in the region, and opacity of the tax collection system in the region. The probability of liquidation is negatively related to most of these factors. And second, introduction of an external management procedure does not change performance of the firms and is not associated with layoffs.

The dependence of Arbitrage courts on regional governments has important implications for the Russian economy. First, there is no pressure on managers of industrial enterprises to restructure. Second, even very profitable projects can hardly be financed by outside investors because the bankruptcy law does not secure their property rights. Third, regional protection of firms against federal tax authorities seriously undermines federal attempts to improve tax collection.

Our findings shed some light on a fundamental question: How does the language of the law affect

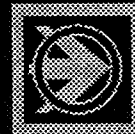
agents' behavior when enforcement is weak and the judiciary is dependent? Our analysis suggests that it may be worthwhile to give up some more sophisticated features of the law, including judges' discretion to avoid inefficient liquidation, in order to secure implementation of the basic objectives of the law.

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EXHIBIT 29

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THE INVESTMENT CLIMATE IN RUSSIA



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economic processes. This problem is made worse by the proliferation of corruption and the use of limited-access (insider) information by the regulatory authorities. The market has punished Russia for this more than once. The 1998 default and devaluation resulted from the unrestrained accumulation of State debt in 1995-1996 for the purposes of achieving political objectives. The oligarchs which were created artificially by the State in 1995-96 for reasons of political expediency have since become a strong obstacle to effective transformations.

The delegation of trust management rights over State holdings in stock companies is ineffective since the interests of the State as a shareholder are damaged. For example, the State representatives in Gazprom voted on a number of occasions against the allocation of dividends, thereby ensuring that the resources remained at the disposal of the company.

In the recent years there has been a marked absence of social consensus in Russia. Economic hardship, the breakdown of society, the reforms and the opposition that was shown thereto have all contributed to maintaining severe conflicts on the political stage and have undermined political stability. All of the factors mentioned above reflect this conflict. There is hope that the situation will change after 2000.

While it is possible to accept the inevitability of such phenomena during the establishment of a new democratic Russia, nevertheless, until such time as they begin to disappear Russia's investment rating will remain low.

2.5. Ownership Rights and Corporate Management

Following the decades of the reign of State ownership, Russia has achieved impressive results in the legislative support of ownership rights. The Civil Code, the Law Concerning Joint Stock Companies, and a range of other legislative acts which meet world standards have been adopted. However, the implementation of these laws has been far from satisfactory.

The recent privatization has created additional difficulties. While there will continue to be debate as to the nature and significance of these problems, it is clear that the radical reform of ownership system in Russia has not been followed by the development of adequate corporate management and control mechanisms. Investment attractiveness has not become a priority objective for the majority of Russian enterprises.

Over the past 3-4 years we have seen an enormous number of incidences of the violation of investors' rights. This has been especially prevalent in companies in which the controlling share package is held by one of the financial and industrial groups. Portfolio investors, who include a large number of foreigners, lose the ability to influence decisions and receive information on principle

issues concerning the activity of an enterprise and are edged out of companies, while at the same time all of the power, including the power to dispose of cash flows and assets, is appropriated by financial and industrial groups.

For example, in March 1999 a number of extraordinary shareholders' meetings took place in the subsidiaries of Yukos. Each of the extraordinary meetings was called to decide upon the same issue — the additional issuance of shares. All of the meetings followed an identical pattern: a share package amounting almost to a blocking package of 25% composed of shares belonging to minority shareholders was arrested under charges of violation of the anti-monopoly legislation. As a result, Menatep, which held the controlling package via Yukos, gained the necessary approval of 75% of the shareholders for an additional emission. Following the emission, the shares were allocated under closed subscription to a number of off-shore companies (presumably owned by Menatep). The new shares were paid for using promissory notes issued by the same subsidiaries, meaning that the enterprises received no cash. The share of the minority shareholders was therefore diluted, and control over the companies passed to Menatep. The minority shareholders who previously held 30% of the shares were pushed out, and the shares lost approximately 60% of their value.

Actions of this type represent the highest possible risk for investors, and especially portfolio investors which usually hold minority shareholdings, and render investment pointless. The seizure of control over an enterprise generally creates the prerequisites for the misappropriation of its assets, the transfer of financial flows to specially established companies, and the eventual bankrupting of the enterprise.

The inadequate regulation of the initiation of bankruptcy proceedings, and the bankruptcy procedure itself, also create serious threats to investor rights. The bankruptcy of Tokobank was a common cause for concern among foreign investors in Russia. The procedure for the appointment of an arbitration manager was violated, and the procedures and conditions used to examine creditor claims caused much consternation. One of the largest shareholders — the EBRD, which is also a Tokobank creditor, was unable to secure recognition of its claims in either of the above roles due to the non-transparency of the bankruptcy proceedings and loopholes in the legislation. According to a major investor, a special market has formed consisting of rogue lawyers who are willing to undertake bankruptcy proceedings against more or less solvent companies in order to allow the misappropriation of their property by interested parties.

A paradoxical situation is to be noted here: enterprises which are sufficiently robust are becoming increasingly subject to bankruptcy proceedings (since there are favorable circumstances for the seizure of control by competitors), while enterprises which are beyond hope are escaping the procedure (since there are no competi-



tors planning a takeover, and the chances of receiving settlement of debts in bankruptcy proceedings are low).

Serious damage is caused to investors when the information prescribed by law on the performance and financial condition of an enterprise is withheld from the investors by managers. In certain cases even the involvement of the FSC and courts of law has failed to persuade managers to comply with the law. There have even been instances of pure arbitrariness whereby the registrars have simply crossed undesired shareholders from the shareholders' register at the request of the management of companies. On the other hand, those financial reports that are supplied and which have often been prepared in accordance with statutory accounting principles, are often useless since the data contained therein are insufficient to allow the accurate assessment of the condition of the enterprise.

The main barriers to the development of an effective system of corporate management in Russia include:

- the absence of effective mechanisms for the re-distribution of property to efficient proprietors; current redistribution usually takes the form of the flow of capital from workers to management without any increase in the share of external shareholders interested in effective corporate management;
- the ownership structure of many enterprises contains a high proportion of affiliated parties;
- the low standards for the disclosure of information on company performance impede the attraction of external investors, and especially foreign investors;
- the rights of minority shareholders are ignored and violated, and the State regulatory authorities and the legal system are as yet unable to provide guarantees of protection thereof;
- many managers of privatized enterprises have no concept of the idea that their responsibility is to the interests of the proprietors (shareholders), and not to sundry interested parties — local authorities, workers.

2.6. Intellectual Property

An important factor which has a negative effect on investor attitudes to Russian projects is the violation of intellectual property rights and counterfeiting of goods. e.g. 89% of the software used in Russia is bought from pirate dealers¹³. Copyright is given little protection, and this serves to discourage many high-technology companies (primarily involved in software production) from setting up operations in Russia. Common practice is the counterfeiting of products which are popular due to quality and advertising exposure. For example, "Ariel" wash-

ing powder, produced by Procter & Gamble has a double with a similar name and identical packaging and design. This illustrates the fact that the law-enforcement agencies view such crimes as being of secondary importance for society and are insufficiently tough towards intellectual property rights violations.

2.7. Virtual Economy and Structural Policy

The term "virtual economy", coined by the US economists Gaddy and Ickes, has become a readily used definition of an economy based on barter transactions and non-payments, such as has emerged in Russia as a result of the preservation of a high percentage of enterprises producing a negative added value. The predominant majority of Russian enterprises are entangled in debts which they have no chance of repaying. They are generally unable to sell their products for cash, and use overstated barter prices reflecting the discount factor of less perfect means of payment, such as commodities or money surrogates. The wide variety of payment methods creates additional transactional costs due to the need to adapt to the conditions of each individual transaction. The economy of non-payments creates preconditions for corporate tax evasion and prompts an increasing number of businessmen to skip their tax obligations, which aggravates the non-payments crisis.

The current spontaneous system of settling non-payments through intermediaries deprives enterprises of 5-10 percent of their funds in payment for mediation services to be subsequently recovered in part in the form of "grease" by the management of companies taking part in offsets.

With a large amount of debt, virtually any Russian enterprise meets the formal criteria of bankruptcy. Realizing the high probability of losing title to an enterprise in case of a possible bankruptcy, investors lack a sense of stability and are unwilling to invest into enterprises. Debts make any investments unprofitable by definition, since the cost of market entry and the investment recuperation period become unreasonably excessive.

In conditions of lenient budgetary constraints and weak corporate control, enterprises accumulate accounts receivable which subsequently turn out to be irrecoverable, and for months on end fail to pay salaries. The State fails to fully finance its contracts, and the population delays payments for utilities.

At the same time, the State uses regional and local budgets to support insolvent enterprises instead of encouraging the development of effective businesses, especially small ones. While this structural policy serves to limit social tension, it does represent a major barrier to the restructuring of the economy and the resolution of social problems.

¹³ "Expert" No. 31, 23 August 1999

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SUMMARY:

[*2261]

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The existence of a burdensome, unfair, and uncertain tax system has been
mentioned almost unanimously, by Russian and foreign observers alike, as one of
the main causes for Russia's lack of investment, stagnant growth, and overall
lackluster economic performance during the transition to a market economy. If
not the most important factor, the inadequacy of the tax system has been ranked
high with factors such as the lack of civil society institutions and the lack of
enforcement of contracts for the transformation of Russia into a full-fledged
market economy. Given the importance of this problem, the paradox of fiscal
policy in Russia during the transition has been the difficulties with, or
rather, the absence of, comprehensive tax reform. Changes in the tax system,
often for the better but sometimes for the worse, have certainly occurred during
this period, but no comprehensive reform has been passed by the State Duma. If
everybody seems to agree that comprehensive tax reform is so crucial, why has it



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not happened?

I. A Brief History of Tax Reform During the Transition

At the time of independence from the U.S.S.R. in 1991, Russia imposed several taxes inherited from the old regime, most significantly the profit, turnover, and payroll taxes levied on and traditionally negotiated with state enterprises. Before the end of 1991, however, a new organizing law, "The Basic Principles of Taxation," and new VAT, Enterprise Profits, and Personal Income Tax laws had been approved. The law on the basic principles has served, with numerous amendments, until the present as a substitute tax code on organizational, procedural, and administrative issues.

The basic law also contained the formula for revenue assignment between the federal and subnational governments, allocating 100 percent of VAT revenues to the federal government and 100 percent of the revenues from the enterprise profit tax (EPT) and personal income tax (PIT) to subnational governments. These provisions of the law were never implemented because of the effective opposition of regional governments. Actually, in the early stages some regions refused to share taxes with the federal government but only on a mutually agreed upon or "single- channel basis." /1/

The VAT law, which for years served as a model for other former Soviet Union countries, had some good features, such as a single rate, but the law also had many problems. /2/

Other problematic pieces of tax legislation were introduced in succession following independence, including payroll taxes to finance social extrabudgetary funds on pensions, excises, and taxes on natural resources. On the whole, from 1992 to 1997 a defective and complex tax system was put in place. Notorious offenders were the EPT, which included a tax on excess wages /3/ and which grossly exaggerated profits by disallowing many ordinary business costs, and a myriad of regional and local taxes. The most significant of these regional and local taxes fell on turnover and payroll, and were introduced during a period of several years when a presidential decree allowed subnational governments [*2262] to introduce their own taxes. The resulting tax system gave Russia a reputation as one of the worst examples of tax reform in transition, and was thoroughly criticized by Russian and international experts and organizations alike. /4/

In 1997 the Ministry of Finance submitted a comprehensive draft tax code to the Duma. This draft tax code had been put together over a period of more than two years under the leadership of then Deputy Minister of Finance Sergei Shatalov and in consultation with foreign experts and international organizations. The Shatalov draft tax code passed on the first of the three required readings of the State Duma on June 19, 1997. /5/ The Duma passed the code in the first reading under significant pressure from the government. President Yeltsin had threatened to dissolve the Duma if they did not vote on the code before the summer recess. The draft tax code had little real support in the Duma, was adamantly opposed by many regional governors, and was criticized and lobbied against by the private sector, especially the banking and natural resources oligarchs who had consolidated their economic power after their support for Yeltsin's reelection in 1996 in the "loans for shares" scheme. After passage in the first reading, the Duma got a revenge of sorts by presenting over 4,000 amendments to the code to be discussed in the fall of 1997, before a



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This issue was brought to a head as a major internal government dispute arose regarding the balance of VAT and the retail [*2269] sales tax. In late December 1998 the government debated the positions of the Ministry of Finance and the State Tax Service, which by then had become the Ministry of Taxation, with responsibility for tax policy and tax administration. The Ministry of Taxation (MinTax), headed by Gregory Boos, a former Duma deputy, wanted a reduction of the general VAT rate to 10 percent, with the institution of a 10 percent regional sales tax. The Ministry of Finance was pushing for a package that would reduce the existing turnover taxes and slightly reduce the VAT rate, with no increase in the sales tax rate, which was 5 percent. A compromise was achieved and a belated budget proposal under the name of the "19 Laws" went forward, with a VAT rate of 15 percent and a regional sales tax of up to 10 percent. These proposals were ultimately rejected by the president and/or the State Duma. The lesson from this episode was that the government had been diverted on many other issues and it had lost its zeal and unified support, if it ever existed, for the draft tax code.

C. Additional Fundamental Factors Against Effective Tax Reform

The adoption of an incomplete and perhaps naive strategy for comprehensive tax reform and the tumultuous economic and political circumstances associated with the August 1998 crisis would seem to be sufficient reasons for the derailment of comprehensive tax reform in Russia. But even if those reasons had not been there, there are several features of the Russian economy that should be expected to have hampered, if not stopped altogether, the tax reform process. The pervasiveness of some of these problems may even have compromised the effectiveness and "curative powers" of an approved tax code.

First, the multifaceted legacy of the Soviet Union has been hard to shed. In the economy, a substantial number of enterprises, even after privatization, continue to operate with negative value added to the economy but survive because they barter with each other, much like they did under the Soviet Union, in what is known as the "virtual economy." /13/ Survival of these enterprises in the noncash economy is favored by the fact that they are allowed to pay taxes and also for energy consumption and transportation [*2270] costs through mutual offsets and other nonmonetary forms that include grossly overvalued prices for the commodities they produce.

Negotiated taxes were the main feature of the tax system in the Soviet Union. After all these years of transition and tax reform, Russia's tax system still retains an important element of negotiation. This is most apparent in how settlements are reached on the payment of arrears. The practice of tax offsets, or mutual cancellation of tax arrears by taxpayers and budgetary arrears by the government (see below) also continues to allow federal and regional authorities to settle and protect particular groups of taxpayers. In fact, tax burdens get customized by taxpayers because typically the value settled in the offset is higher than the actual value of what the government has received from the taxpayers.

* * * * *

Box 3

Views of Key Players



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The views on the causes of the failure of comprehensive tax reform expressed in personal interviews by several Russian government and Duma officials who have been key players in the process over the past several years are diverse.

The Tax Policy Department of the Ministry of Finance has been the center of the tax reform effort for the government. Mikhail Motorin, deputy minister in charge of tax policy, believes that the passage of the tax code was hampered by closely intertwined political, economic, and social issues. He points out that there is a conflict between the current high rates of taxation and the lower tax rates called for in the draft tax code, which would require, at least in the near term, significant expenditure cuts. This dilemma feeds directly into Duma politics because it is easier to support tax decreases but more difficult to support expenditure reductions. Motorin also emphasizes the distant positions of political parties in the Duma, with the Communist party calling for personal income tax rates in excess of 70 percent and the Yabloko party calling for a flat 10 percent tax rate. His deputy, Alexander Ivaneev, also long an actor in the development of tax reform in Russia, points out that the draft tax code has been a good instrument for factional politics in the Duma. Deputies have been in no hurry to solve this "big" issue, which elicits many emotions from constituents and supports the deputies' reelection agenda.

The head of tax policy in the Ministry of Taxation, Sergei Shulgin, expressed the opinion that the government itself has had difficulties in developing a strategy for engaging the State Duma in the tax code debate. The cause of the failure fell more on strategy and less on the substance of the tax reform. Duma Deputy Svetlana Orlova, chair of the Subcommittee on Taxation of the State Duma Committee on Budget, Taxation, Banking, and Finance, listed different reasons for the lack of comprehensive reform. First, the entire concept of tax reform in a country as large and diverse as Russia should be expected to be very difficult to accomplish. Second, the complexity of the draft tax code made it difficult for the Duma deputies to discern its impact on their diverse regions and interests. Third, some versions of the draft tax code had been associated with the "western reformers," which did not sit well with the communist majority in the State Duma. Finally, the federal government and regional governments are not in fundamental agreement over the match of their respective expenditure responsibilities and the tax sources assigned to them. In this respect, regional representatives end up being suspicious of federal government tax proposals.

FOOTNOTE TO BOX 3

/a/ This position has been challenged since the issuance of Presidential Decree of December 25, 1998, which created the Ministry of Taxation out of the State Tax Service. Under this decree, tax policy was brought under the purview of MinTax. Since May 1999, the role has gone de facto back to the Ministry of Finance.

END OF BOX 3 FOOTNOTE

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Other features of the Soviet tax system have died hard. Under the previous regime, taxes completely lacked transparency. Often, enterprises did not know what other taxpayers facing similar circumstances paid in taxes and the population at large were neither aware of taxes nor had any perceptions of tax



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burdens. Very few individuals actually filed tax returns, paid taxes during transactions, or were aware of the existence of turnover taxes or profit taxes. That tax system created a taxpayer culture of mistrust of government and of noncompliance that endures today. Taxpayers believe that tax burdens are distributed arbitrarily and that the government is wasteful if not corrupt. Many taxpayers continue to refuse to pay taxes through nonfiling, underreporting of income, and many other forms of tax evasion.

The other side of the legacy from the Soviet Union is a weak [*2271] tax administration system. Although in Soviet times tax administration had a small capacity, it was able to enforce taxes because taxpayers were large in size and small in number, there were restrictions on payment methods through the state bank monopolies, and in fact tax administrators could retroactively adjust rates and procedures to meet revenue quotas. The transformation of this tax administration system into a modern tax administration required to enforce taxes in a market-based economy has been painfully slow. The State Tax Service of the Russian Federation, introduced right after independence as a federal agency with regional and local offices, is still primarily organized by type of tax or by type of taxpayer, with the majority of functions located at the lowest level of administration, the local tax inspectorates.

The control exercised by the headquarters of the Ministry of Taxation, the new name for the tax administration, over collections, returns, processing, audit, or appeals in the local and regional offices continues to be weaker than in most other tax administration systems. Because regional and local governments have continued to pay for the housing, bonuses, and other aspects of the compensation of local administrators, there continues to exist a significant de facto allegiance of tax administrators to the interests of subnational governments which in many cases differ from the interests of the federal government. This de facto dual subordination of local tax administrators has been a constant source of problems with the tax system during the transition. /14/ Tax administration continues to be collections-oriented, not taxpayer-oriented, and has created a climate of distrust and suspicion among taxpayers. High compliance costs are imposed on taxpayers, who often must purchase tax forms and instructions and are required to file taxes in person in many cases on a monthly basis. The lack of reform of the tax administration to some degree trivializes the lack of comprehensive reform in tax policy.

Tax evasion is widespread and has remained high during the transition. Estimates of the amounts of taxable income moved offshore every year are in the magnitude of US \$ 10 billion to US \$ 20 billion or equal to between one- and two-thirds of projected total government revenues for 2000. A review of the existing estimates of tax evasion shows significant leakages in Russia's tax system, with PIT compliance estimates at approximately 50 percent, EPT around 60 percent, VAT in the range of 38 to 55 percent, and excises on alcoholic beverages close to 50 percent. These estimates add up to a huge loss in revenue due to noncompliance.

Arrears are a pervasive fact in the Russian economy and have had a significant impact on the performance of the tax system. Accumulated tax arrears, which are composed of delinquent payment of taxes and deferred payments as agreed between the tax authorities and taxpayers, at the end of 1998 were close to total tax collections. And while tax collections at the federal and subnational level increased by 149.3 percent between 1995 and 1998, in the same



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period tax arrears increased by 584.8 percent. The growth in tax arrears since 1996 has been dramatically enhanced by the federal and subnational governments' practice of tax offsets. Both enterprises that can pay and those that cannot pay their taxes on time can benefit from tax offsets and the development of arrears. Granting tax offsets has become addictive behavior in federal and subnational budgetary practices. Despite the many problems tax offsets have created, they offered the fiction of higher levels of expenditures and better balanced budget execution. The use of periodic tax amnesties to combat arrears by the tax authorities appears to have been another factor in their growth. /15/

The broad perception among taxpayers of corruption of government officials continues to contribute to an unwillingness to pay taxes and undermines the basic fabric of society. Although high-profile cases of possible corruption have captured the attention of the international media recently, at least as damaging for the tax system is the belief by Russian taxpayers that tax administration officials are corrupt. However, there are no formal studies of the size or significance of this type of corruption. [*2272] The problem seems to be centralized at the middle and lower-rank level of the tax administration, with those who have direct contact with taxpayers and have had an interest in maintaining the status quo. However, the damage to the tax reform effort from this type of corruption has been less through the influence this group may have had on the policy process that involves tax reform than through the demoralization of ordinary taxpayers and the strictures legislators have felt they need to impose on tax enforcement.

Reforming a tax code is a difficult and complex procedure, and it requires support and compatibility with other laws and institutions in the system. We have seen that, at least in part, the demise of the Shatalov draft tax code was predicated on its inconsistency with other laws, in particular the Civil Code. This problem was addressed by the new draft tax code. However, there are still many laws and government institutions that represent powerful barriers to the implementation of the tax code.

One case in point that highlights the difficulties of developing a significant change in tax legislation is the experiment on the real estate property tax. This tax was proposed in the draft tax code as a substitute for three Soviet era property taxes: a land rent tax, a tax on buildings, and a tax on enterprise assets. Its introduction was postponed until an experimental pilot was completed in the cities of Novgorod and Tver. The arduous history of this experiment provides a prime example of the difficulties faced in the modernization of the tax system in Russia. One of the main problems has been the lack of coordination among government officials at various levels of government and among different laws of the Russian Federation that do not provide appropriate institutions or clear lines of authority. Title registration alone is under the purview of four federal agencies, and privatization of land and some structures is still crippled by politics. The property tax experiment [*2273] remains a good example of how diverse interests in government and the private sector have worked hand in hand to slow down or actually block, as in the case of the property tax, reform (see Box 4).

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Box 4



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Real Property Tax Experiment

The development of a real property tax has been conducted via an "experiment" in the cities of Novgorod and Tver. The process has been a long one, beginning in late 1995 and continuing today. The following description of part of the process may help to give an indication of the complicated interplay among agencies, governments, and individuals that has been part of this one reform.

Fiscal cadastre creation: Development of a fiscal cadastre requires the review of title registration for properties. In many instances, the property committees of the cities had incomplete records, or misleading records (falsification of title ownership via shadow business, for example). Because the title registration process has not been fully developed, the cities had to do much investigative field work on their own. This held up the entire cadastre creation and additional resources had to be allocated to its creation. Federal legislation regarding title registration and property rights clarification has not been forthcoming. Such legislation is under the purview of the State Land Committee, Ministry for State Property, and the State Committee for Construction. Because it relates to taxation, the Ministry of Finance would also have a role in the legislation.

Valuation of properties: There is no legal framework for valuation methodology at the federal level. Development of a legal framework needs to be a coordinated effort of federal, regional, and local officials. There was also the obvious public reaction to market-based valuations of properties -- many individuals and business owners were very skeptical at first and believed it meant higher taxes (in fact, discussion of a property tax in some well-off municipalities around Moscow were promptly dropped due to citizen reaction).

Intergovernmental fiscal relations: The original intent of the real property tax was that it be a local government (city) revenue source and that it replace certain other local taxes. Both the federal and regional governments lobbied at various times to list the tax as a federal or regional tax, to be shared with the local governments. Debates arose regarding which level of government should pay for the creation of a fiscal cadastre, title registration, valuation, etc. The current pending federal legislation on the property tax states that the tax is to be shared between the regional and local government.

Compliance: Because the real property tax is a new tax, the regional tax administration had no experience administering such a tax. In addition, due to political and technical difficulties, the tax administration will have difficulty obtaining the fiscal cadastre data. There was need also for coordination regarding billing. The property tax committee in each city (newly established) could not technically issue bills, but the tax administration could not do so, either due to administrative constraints (the property tax was not listed as one of their collectible taxes and they did not have access to the valuation and cadastre information). In the end, a compromise was reached whereby the property tax committee would issue "bills" without a statement of liability, but would include all necessary information for the taxpayer to determine their liability (assessments and tax rates).

END OF BOX 4

III. Concluding Comments



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The coming legislative election to the State Duma in December and for the presidency in July 2000 may break the political logjam in government but it will not be a miracle cure for the many problems that affect the Russian economy. Even if the draft tax code were to be passed in the future there are serious problems with tax administration and evasion, corruption, arrears, tax offsets, and complementary legislation and institutions that will compromise the effectiveness of comprehensive tax reform.

To a large extent opposition in the Duma to comprehensive tax reform has often been old-fashioned partisan politics and opportunistic obstructionism led by the opposition forces dominated by the Communist party but also by the liberal Yabloko party. The lack of support by these political forces has also had ideological underpinnings. Whether there will be a political force with absolute majority in the Duma after the December 1999 elections is uncertain at this time. But in this unlikely event the new Duma may still be in opposition to the president's political forces. Thus the chances of comprehensive tax reform in Russia before the June 2000 elections are slim.

There is a far better chance for piecemeal reform to continue in the months ahead. Most of the tax measures being pushed by the federal government with the 2000 federal budget represent improvements to the current tax structure. In fact, many of the tax changes introduced piecemeal over the last 20 months have been in the direction of lower rates, reducing differential taxation among forms of income, and reducing the complexity of the current system. But not all changes have been positive. For example, the desperate search for revenue has led to the passage of administrative measures that have unreasonably increased the compliance costs for taxpayers.

Many of the "big" tax policy problems still remain: lack of accrual accounting for VAT, absence of full deductibility of business costs, numerous exemptions in the enterprise profits and individual income taxes, the overwhelming number of taxes (some based on turnover at the subnational level), inconsistencies among various tax laws, and a defective tax administration system. Whether continuation of the piecemeal approach will be effective in tackling any of these issues remains an open question. /16/

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EXHIBIT 31

Without a Map

Political Tactics and
Economic Reform in Russia 869

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cent of GDP at the end of 1994 to 15 percent at the end of 1997. Interest payments increased from 19 percent of federal spending in 1995 to 24 percent in 1997, and 34 percent in the first eight months of 1998.⁸ This was in addition to the \$125 billion in foreign debt that the Russian government had accumulated or inherited from the USSR by the beginning of 1997.⁹

From one perspective, the contraction of tax revenue in Russia in the 1990s might appear to be a natural—even desirable—development. Replacing a centrally planned economy with a free-market system *should* involve a reduction in the size of the state. Lower tax collection might represent a kind of backdoor liberalization, and the blame for budget deficits might fall on inadequate cuts to public spending. Indeed, Vito Tanzi has argued that countries at Russia's level of economic development normally collect 15 to 25 percent of GDP in tax revenues.¹⁰ By this metric, the combined government in Russia should—if anything—be shrinking.

However, if the goal is to reduce growth-retarding government intervention in the economy, a smaller government is not necessarily a sign of success. Small and shrinking states do not tend to be more economically liberal. Indeed, cross-national statistical comparisons suggest that the quality of government performance—as measured by just about any indicator, from low corruption to low infant mortality to more benign regulation—correlates *positively* with the size of government, as measured by the share of tax collections in GDP.¹¹ This is true even when controlling for countries' levels of economic development. The most market-friendly governments in the late twentieth century tended to be those that collected and spent the most revenues. Most states with small governments are illiberal, repressive, and unfriendly toward markets. One should not expect Russia's or any other government to enact more liberal policies only because it shrinks.

But nor should it be assumed that the quality of government can be improved *simply* by increasing its size. Quantity does not buy quality. This notion appears to have motivated a group of distinguished American economists, including several Nobel laureates, who in 1996 argued that a sharp increase in the size of the Russian government would solve its economic and social problems.¹² The model they appealed to was Sweden's social democratic welfare state. The trouble with this analysis is that it lacks any mechanism for improving the quality of government. As long as the Russian state remains interventionist, corrupt, and distortionary, increasing its size is unlikely to

leave Russians better off. Attempts to turn Moscow into Stockholm may turn it into Nairobi instead.

Furthermore, the salient question in Russia was not so much the size of the state as a whole as the size of the central government. As noted, revenues at the regional level and below remained roughly constant as a proportion of GDP in the 1990s (though falling sharply in real terms). Russia's enlarged budget revenues—34 percent of GDP in 1997—were not low for a country at its level of development. But Russia's *central* budget revenues (13.1 percent of GDP in 1997) were small even compared to equally poor countries. The average for countries with per capita GNP within \$200 of Russia's in 1997 was 19.0 percent of GDP (if GNP per capita is calculated by the World Bank Atlas method) or 19.9 percent (if GNP per capita is calculated at purchasing power parity).¹³ If one accepts the estimates of Johnson et al. (see below) that by the mid-1990s Russia's unofficial GDP came to about 40 percent of official output, federal revenues would be an even smaller share of GDP.¹⁴

In short, the level of central government revenues—though not general government revenues—that Russia has been able to collect is low by international standards. The federal government has scaled back its spending very dramatically, but not by enough to eliminate large budget deficits given the collapse of federal revenues. Attempts to cut federal spending still further have sparked intense political fights and weakened central leverage over politicians in the regions.

Expanding Unofficial Economy

As tax revenues fell, the unofficial economy expanded. Measuring such trends is difficult, but some scholars have estimated unofficial economic activity by comparing official GDP figures to those extrapolated from electricity consumption, which is harder than most other indicators of economic activity to conceal.¹⁵ Johnson et al. estimate that Russia's unofficial economy grew by nearly 9 percentage points of GDP between 1992 and 1995 to reach 42 percent of GDP, a total exceeded among the countries they studied only by unreformed Ukraine and war-torn Georgia and Azerbaijan.

The desperate measures the government took to beef up tax collections probably exacerbated the arbitrariness of the tax system and accelerated the exodus into unofficialdom. Entrepreneurs complained about the bewildering number of taxes, whose aggregate rates, they suggested, added up to close to 100 percent of enterprise profits or

even revenues. As of 1997, there were about 200 identified taxes in Russia.¹⁶ In Moscow, in 1995, firms were required to submit twenty-three different tax forms every quarter.¹⁷ According to one Moscow-based senior banking partner with the auditor Price Waterhouse, each of his clients had "paid a tax charge in excess of 100 percent of pretax profits" the previous year.¹⁸

An enormous number of exemptions exacerbated the appearance of unfairness.¹⁹ By the estimate of Deputy Finance Minister Sergei Shatalov, in early 1997 tax breaks established by legislation amounted to 160 trillion rubles (7.3 percent of 1996 GDP) of which 100 trillion rubles' worth had been granted by regional authorities.²⁰ A panel of experts assembled by the *Central European Economic Review* in late 1995 concluded that the level of fairness of taxes in Russia was lower than in Kazakhstan, Moldova, Bulgaria, Romania, Hungary, Poland, the Czech Republic, Slovakia, and all three Baltic republics. Russian taxes were judged fairer only than those in Uzbekistan, Belarus, Ukraine, Georgia, and Azerbaijan.²¹

Such situations are highly unstable. As the government tries to increase its revenues by raising tax rates and making tax collections more arbitrary, the effect is often to drive businesses underground and to prompt those above ground to invest more effort into tax avoidance. The consequence is a further reduction in tax collections and in the general quality of government, making official business ever less attractive. Economists warn of the danger of "tipping," as economic actors desert the official economy for less public alternatives and the public economy continues to shrink.²²

By 1997, tax and regulatory evasion and unofficial activity in Russia and some of the other post-Soviet states had reached extreme levels. That year, one group of scholars surveyed about 300 firms from a variety of sectors in each of the cities of Katowice (Poland), Brasov (Romania), Bratislava (Slovakia), Volgograd (Russia), and Dnepropetrovsk (Ukraine).²³ When asked what proportion of sales a "typical firm" in their industry tended not to report, Russian managers gave a figure of 29 percent on average, compared to figures of 5 to 7 percent for the Slovak, Romanian, and Polish managers. The reported level of underreporting in Ukraine was even higher—41 percent—undetermining the often-heard argument that rapid stabilization and privatization are responsible for Russia's pathologies. While 74 percent of Polish firms said that no sales were hidden, only 32 percent of Russian firms and 1 percent of Ukrainian firms said the same. Estimates of the

frequency with which salaries were underreported were similar in the respective countries.

Nonmonetary Exchange

Businesses that remained in the official economy increasingly avoided the use of money. Instead, they ran up arrears to suppliers, government, and workers; bartered goods; or used money substitutes of one sort or another. The level of overdue payables of enterprises in industry, agriculture, construction, and transport doubled from 15 percent of GDP at the end of 1994 to 29 percent at the end of 1997.²⁴ The major victim of this accumulation of nonpayments was the government. The share of arrears to the budget and extra budgetary funds in this total grew from 21 to 42 percent during the same period, while the share of arrears to suppliers fell from 63 to 46 percent.

Another way of avoiding the use of money was to transact by barter. One monthly survey of industrial enterprises found that the reported share of barter in industrial sales had risen to 45 percent by April, 1997.²⁵ Another survey of 350 enterprises in Russia in October and November 1998 found that almost 90 percent had exposure to both barter and tax offsets—the payment by governments for goods and services by waiving suppliers' tax obligations.²⁶ As discussed in chapter 6, there were several reasons for the spread of barter. It was a way of avoiding holding cash in bank accounts that could be confiscated by tax collectors if taxes went unpaid.²⁷ It was also a way of getting around a law that prohibited selling below cost—prices could be artificially manipulated in a barter deal. In addition, paying taxes in kind rather than in cash was a way to favor the regional and local over the federal budgets, since accepting tax payments in concrete or cucumbers was easier for a city government than for the State Tax Service in Moscow. The 1998 enterprise survey found that while "the monetary share of federal tax payments averaged over 60 per cent, in the case of local taxes and off-budget funds, offsets and barter accounted for 60 to 70 percent of the value of payments."²⁸ At the same time, some exchanges that looked like barter—the trading of fuel for shoddy goods, for instance—could better be described as a kind of politically motivated welfare (see chapter 4).

Third, enterprises that did not wish to hold rubles could transact in promissory notes (*veksels*), issued by regional governments, banks, or enterprises themselves. The stock of *veksels* issued by credit institutions

rose from about 7.5 percent of broad money in July 1996 to about 12 percent in mid-1998.²⁹ Including vekselns of nonfinancial enterprises and of different level governments would increase the total still more.

The use of barter and money substitutes imposes clear costs on firms. Enterprises surveyed by Commander and Mummensen were quite emphatic that the use of barter offsets or vekselns took more time than transacting in cash. Sixty-nine percent said that barter took "much more time." A majority also said that prices in barter deals tended to be higher. Forty-eight percent of those using barter or offsets said that such deals were profitable for neither them nor their partner—which, of course, begs the question why enterprises continued to engage in them. Interestingly, enterprises did not report higher storage costs or any impact of barter on their willingness to modernize products.³⁰

Weakness of Small Firms

Small firms are widely viewed as the engine of growth in transition economies.³¹ The number of small firms in Hungary increased by 175 percent in 1990, 109 percent in 1991, and 30 percent in 1992. In Slovenia, small firms increased by 82 percent in 1991 and 25 percent in 1992.³²

Unlike in much of Eastern Europe, however, the growth of small business in Russia in the late 1990s was unimpressive. The number of registered small enterprises increased markedly in the early years of reform, from 560,000 in 1992 to 897,000 in 1994.³³ But in 1995 the total actually fell to 877,300. The Goskomstat definition of small enterprise changed in 1996, rendering comparisons with earlier periods difficult. A survey conducted by the government's Center for Economic Research, however, revealed a fairly dismal situation for small businesses in late 1997.³⁴ In industry, small firms reported falling output and a worsening economic situation more frequently than did medium or large businesses. The proportion of small firms reporting a worsening economic situation grew from 33 percent in the first quarter of 1997 to 38 percent in the fourth; among medium and large enterprises, the share actually dropped from 34 percent to 31 percent during the same period. In retail trade, fewer small businesses than medium or large enterprises reported increasing sales, and economic results generally improved as the size of the firm increased. Entrepreneurs in retail trade pointed to the high tax burden more often than any other factor (81

percent of respondents) to explain the limited development of small businesses. Among industrial small enterprises, the tax burden was surpassed only by lack of financing (65 and 75 percent of respondents respectively).

The weakness of small enterprise, along with the other pathologies we have listed, coincided with a period of continuing stagnation, even after macroeconomic stabilization had been achieved. Official estimates of real GDP dropped in 1995 (by 4.1 percent) and 1996 (by 3.5 percent), and rose only slightly in 1997 (.8 percent), before dropping again in 1998 (by 3.1 percent in the first nine months of the year).³⁵

Diagnosing the Syndrome: Some Partial or Unconvincing Answers

What lay behind the persistent stagnation of 1995 to 1998? Why did federal revenues continue to fall? Why did much of the economy demonetize or shift underground? Why did small business fail to develop in Russia as rapidly as elsewhere? Why did official output continue to shrink even after macroeconomic stabilization had been achieved? Scholars and journalists have suggested a number of explanations for some or all of these phenomena. Some of the factors mentioned do contribute to an explanation. But they do not entirely solve the puzzle.

Cultural Traits

Some observers have attributed Russia's problems—economic stagnation, tax evasion, corruption—to supposed underlying cultural traits of contemporary Russians, in particular to a post-Communist distrust of the state or an underdeveloped respect for legality. Russians, it has been argued, lack a tradition of civic responsibility and participation. According to one *New York Times* reporter, getting Russians to pay taxes "will require nothing less than an act of religious conversion."³⁶

The hypothesis that cultural factors explain declining Russian tax revenues does not fit well with the variety of observable experience, both in Russia and in other post-Communist countries. If the Communist legacy explains poor tax compliance, it is puzzling that other post-Communist countries such as Poland and Latvia have actually seen general government revenues rise relative to GDP in recent years (see table 5.2). Even Ukraine and Uzbekistan—two states where

in 1990 and its staff was recruited predominantly from members of the regional administrative bureaucracy, usually from the relevant region's finance department. There was no system of geographical rotation like that employed by the U.S. Internal Revenue Service, and the career path of advancement from regional to central tax offices was too exceptional to provide incentives for hierarchical loyalty.

Historically established personal ties between regional tax collectors and the regional administrations were cemented by economic dependence. STS officials in the regions increasingly relied on the regional administration for housing, benefits, even at times for wages or wage supplements. In the first half of 1997, the federal government allocated 60 billion rubles to fund the STS branch in oil-producing Khanti-Mansiiskiy Autonomous Okrug (AO). In the same period, however, the branch reported spending 320 billion—of which 260 billion must have been provided by the regional administration.⁷ Perhaps not coincidentally, Khanti-Mansiiskiy AO had the largest nominal arrears to the federal budget of any Russian region in 1996.⁸

In summary, the Russian tax system in the 1990s had the following five features:

1. A federal organization, with federal, regional, and local governments all entitled to adopt independent budgets.
2. Dependence of all levels of government on shared taxes for the majority of their tax revenues.
3. Broad discretion for the regional governments over how to share major taxes with localities in their jurisdiction.
4. Authority (between December 1993 and 1997, and after that the ability in practice) for regional and local governments to introduce new taxes within their jurisdiction and set rates at their discretion.
5. Collection of taxes by the STS, a federal body whose regional branches had come to depend materially on the support of the regional governments.

Incentive Problems

Various aspects of the system described in the previous section created perverse incentives. These incentives, in our view, help to explain the falling federal revenues, growing tax evasion, stagnant economic growth, and widespread unofficial economic activity in most regions of the country. We focus here on four main problems.

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Overlapping Tax Bases

If different levels of government can unilaterally impose additional taxes or raise tax rates on the same base, and if high taxes stimulate tax evasion, a standard "tragedy of the commons" problem arises. When more than one revenue-maximizing government has the right to "graze" the same tax base, the "commons" of economic activity are soon "overgrazed" and little grass remains.⁹ High aggregate tax rates depress economic activity and drive firms underground. Above a certain rate, this move into the unofficial economy reduces the total tax take. All levels of government would be better off if they could agree to lower rates across the board. But if any one level of government shows unilateral restraint by setting lower rates, it reduces its own revenue and directly benefits all the other levels of government. It also creates an opportunity for the other levels to increase their tax rates, grabbing a larger piece of the pie for themselves. The general result is a suboptimally high total level of taxation, and as tax rates ratchet upward, entrepreneurs choose not to invest or disappear into the unofficial economy.¹⁰

Tax Sharing

Suppose that different governments are not free to levy taxes autonomously on an overlapping base but each receives a fixed share of revenues from a shared tax. The overgrazing problem can then be addressed by setting the aggregate tax rate at the revenue-maximizing level. Yet governments remain in competition over how the tax take should be distributed among them. Given any official scheme for sharing the revenues from particular taxes, each government will try to steal the other government's share. We describe the specific strategies of such theft below, but the general method is for one level of government (usually the regional level) to help firms to conceal part of their taxable operations from the view of the other main level of government (the federal level), thus reducing the firms' tax payments. In return, the firm makes transfers in cash or in kind to the government that has helped it. In effect, the enterprise and colluding government split the other level of government's share between them. Both the firm and the colluding government reap financial benefits, although accomplishing and concealing such thefts often imposes large costs in wasted resources.

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As already noted, the main taxes in Russia in the 1990s were shared in fixed proportions between federal, regional, and local budgets. From 1994 on, the federal government was officially entitled to three-quarters of VAT and a little more than one-third of profit-tax receipts; the regional and local budgets got the rest. Both firms and regional governments engaged in a complicated set of maneuvers to evade or reduce the collection of the profit tax.

Tax Collectors—Servants of Three Masters

When some taxes accrue to a particular level of government but others are shared among the levels—as is the case in Russia—each level of government would prefer the tax collectors to prioritize the collection of its 100-percent-owned tax. Under such conditions, control over the tax collectors becomes crucial. The STS is formally a federal body. But, in practice, regional STS directors depend upon and are influenced by regional governments; and local STS directors also rely upon and have to take into account the views of local mayors. One consequence of this is the generally more effective collection of 100-percent-owned than of shared taxes. This creates a problem for tax revenues since the largest taxes are shared.¹¹

Another consequence is the disorientation and inaction of tax officials, as they feel their loyalty stretched in different directions and fear to offend any of the interested parties. In matters of conflict between regional and federal governments, they risk on one hand being disciplined by the Moscow head office, and on the other losing benefits and local administrative support. One typical response, according to the chairman of the Tver city council, is for officials at such moments to “call in sick and check into the hospital” until the dispute blows over.¹² In general, though, it is easier to fool the center while keeping on good terms with the regional governor than it is to do the reverse.

The tax collectors’ divided loyalties have two important consequences. First, when the head of the regional tax service is hiding or in the hospital, the effectiveness of collection is bound to suffer and revenues will fall. Second, the dual subordination of tax collectors in practice gives them considerable leeway to play off one level of government against the other. Using one to shield them against the other reduces the STS officials’ risk of being found out and penalized for corruption. Such cover may, in turn, increase their ability to prey on

local firms, pushing such firms increasingly into the unofficial economy and depressing growth.

Confiscatory Tax Adjustment

Incentives for governments to support economic growth and effective tax collection are undermined not only by the way revenues and authority are divided between levels of government in a given year but also by the way such divisions change over time. For governments to have an incentive to try to improve tax collection, they need to know not just that their efforts will be rewarded this year, but that they will benefit—or at least not suffer—in the future. In Russia, the opposite has often been the case. Both regional and local governments have had their fiscal benefits reduced by higher levels when they have succeeded in increasing the effectiveness of tax collection. They have been victims of the infamous “ratchet principle.”¹³

At the regional level, the ratchet effect is built into how transfers to support regional budgets are made. From 1994, transfers to support “needy” and “especially needy” regions have been allocated from the federal budget out of a Fund for Financial Support of the Regions (FFSR), ostensibly under a predefined formula. This formula allocates higher transfers to regions with lower revenues and higher budget deficits in the “base” year.¹⁴ The base year has continually moved forward, however, and has usually been just one to three years prior to the year in question. As a result, regional governors know that any improvements in tax collection in their regions or reductions in their budget deficits quickly lead to lower allocations of transfers from the FFSR.¹⁵

The same problem appears at the local level. Municipalities in most regions receive fiscal transfers from the regional government’s budget as well as negotiated shares in certain taxes. Regions differ in the mechanics of how they determine such allocations. Some use formulas similar to that of the FFSR, others employ less formal procedures. Ekaterina Zhuravskaya has compiled some relevant evidence based on fiscal data from thirty-five large cities in twenty-nine regions between 1992 and 1997. Her data suggest one feature common to many of these schemes: increases in tax collection at the local level tend to be offset almost entirely by subsequent reductions in transfers and tax-shares from the region.¹⁶ Of each additional ruble raised at the margin, more than 90 kopecks were “taxed away by the regional government

through decreased tax shares and transfers." It is hard to imagine a stronger disincentive to improve tax collection or grow the tax base.

This finding is echoed by various local officials. According to Valery Pavlov, head of the Tver city council, confiscatory adjustment of the tax-sharing rates made it disadvantageous for the city to collect additional taxes.¹⁷ In a ruse to get around this, the city once temporarily abolished all local taxes on December 28, so as not to have to report the revenues from them in year-end accounting to the oblast, and then reinstated them in early January. Had the oblast been given information about the city's tax receipts, city officials were convinced that it would have reduced the portion of shared taxes the city was allowed to retain. The greatest problem, according to Pavlov and to the mayor of Tver, Aleksandr Belousov, was not the terms of tax division themselves but the impossibility of planning ahead, given continual changes in the fiscal rules of the game.¹⁸

The knowledge that any increase in local tax revenues due to better collection or the growth of the local tax base will be confiscated reduces incentives for local authorities to keep their venal officials in check and to support economic growth. This drives firms underground and depresses investment.

The incentive problems discussed in this section have a number of consequences. First, they reduce the level of tax the federal government is able to collect, forcing it to cut spending even more drastically than planned or to run large budget deficits. Second, high aggregate tax rates and the instability that competitive tax setting generates encourage enterprises to hide output in the unofficial economy. Investment and growth are also likely to suffer. The following section explains how these problems arise.

Stakeholder Responses

Games Regions Play with the Federal Government

Responses to Overlapping Tax Bases

The right of different levels of government to levy their own taxes on common tax bases was viewed in Russia as a key element of federalism. As noted, a December 1993 presidential decree authorized regions and localities to introduce additional taxes beyond those formally assigned to them by law. The impact of the decree was rapid. In 1994, regions and local governments introduced more than 100 different new

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a certain number of veksel and use them to pay for public services from local utilities and enterprises. These utilities and enterprises could then use the same bills to pay their regional and local taxes. Since veksel were not accepted by the federal budget, taxes paid in this form could not be shared. Legislation in 1997 heavily restricted the issue of veksel by regional governments but not by local banks and enterprises, which quickly stepped into the gap. A commercial bank would issue veksel, selling them at a discount to regional enterprises, which would then use them to pay taxes. The regional government would in turn redeem them with the issuing bank. For their troubles, the banks often earned a healthy profit on such veksel operations by offering the veksel at rates below the market interest rate.

To avoid sharing taxes with the federal government, regional governments also wrote off the regional tax obligations of local companies in return for public services they provided. Rather than having an enterprise pay its tax in cash, which would mean splitting the revenues with the federal government and using its share to pay for public services, the regional government had public services provided directly, while the firm got to keep the portion of the tax that would have gone to the federal budget. In April 1999, the governor of Kemerovo Oblast, Aman Tuleev, announced that all enterprises in the region would soon begin to make additional monthly "donations" to state sector employees. Those that refused to make such "voluntary" contributions might have their director replaced or an external administration imposed on them.²⁷ Finally, regional and local taxes were often paid by enterprises in kind, a means of payment the federal government generally found too expensive to accept. Tax evasion—especially the evasion of *federal* taxes—was a major reason for the spread of barter among profitable enterprises. If all transactions were settled in kind and no cash appeared in the enterprise's (official) bank accounts, it could run up arrears to the federal budget with relative impunity. The regional budgets, meanwhile, were better equipped to accept tax payments in kind. As of 1996, the average proportion of taxes paid in cash to regional budgets in thirty-three surveyed regions was only about 50 percent.²⁸

In explaining the widespread use of barter, two types of enterprises need to be distinguished: those that could sell their output profitably for cash and those that could not. Profitable and unprofitable enterprises had quite different motivations. For those that could sell their output profitably, barter had two functions. First, it represented a way to avoid holding cash and thus avoid its seizure when they chose not

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Attempts at Tax Reform

Reformers attempted to pass new tax legislation several times in the 1990s. An initial spurt of legislation occurred in the first months of the Gaidar government in late 1991. A second major offensive took place in 1997, while Chubais was coordinating economic reforms. On each occasion, the important changes were either blocked at the enactment stage or not implemented. The reasons for this are easy to see if one considers the expected impact of each reform on the key stakeholders.

The incentive to overgraze a common tax base and to cheat the other level of government in a tax-sharing scheme could have been reduced by separating more clearly the tax bases assigned to different governments and by eliminating tax sharing.⁶ On at least two occasions, serious efforts were made to move in this direction. The first came in the early days of reform. The Basic Principles of Taxation Law, passed by the Supreme Soviet in late 1991, foresaw a division under which VAT revenues would accrue entirely to the federal budget, while receipts from the enterprise income tax—the precursor of corporate profit tax—would belong exclusively to regional budgets.⁷ Despite being passed by the legislature and enacted into law, this provision was never implemented. Regional governments resisted and were able to prevent the change. In 1992–93, the efficiency of the tax system took a back seat to preserving the country's territorial integrity and forestalling regional revolts. The sharing of these taxes between center and regions continued at frequently renegotiated rates.

Why did regional governors oppose such a change? A little arithmetic makes this clear. Roy Bahl estimated the effect full implementation of the provisions of the Basic Principles law would have had on regional revenues, using the actual revenues collected in the first quarter of 1992 as the base for his calculations.⁸ His conclusions are dramatic. In aggregate, the subnational government sector would have gained from the change. While subnational governments would have lost about 30 billion rubles in VAT revenues, they would have gained about 66 billion in personal and corporate income tax. Still, a majority of individual regions would have come out worse off. "The median oblast would lose R 29 per capita, equal to 4.29 percent of revenues. Of the sixty-nine oblasts analyzed, forty-one (60 percent) would lose an average of R 118 per capita—fully 20 percent of their revenues."⁹ In other words, for a majority of regional leaders support

of the tax-reassignment provisions would have required a considerable sacrifice.

Systematic tax reform reemerged as a priority in late 1994, when to simplify and formalize current arrangements the government began drafting a new tax code and budget code. Early drafts of these codes, prepared by reformers in the Ministry of Finance, again envisioned assigning VAT entirely to the federal budget and profit tax to the regions. Debate on these bills came to a head in 1996–97. Again, regional governors objected. By the summer of 1997, the idea had been dropped. In late July, a somewhat chastened Sergei Shatalov, the deputy minister of finance responsible for coordinating the government's position on the tax code, said that a proposal to assign VAT or profit tax exclusively to one level of government would not be made by the government again any time soon.¹⁰

Why was this idea still so unattractive to regional governments? By this point, not only would a majority of regions have lost revenue from such a change but regional budgets would have lost a substantial sum in the aggregate. In 1996, the federal budget's receipts of profit tax came to about 1.4 percent of GDP while the regional budgets' receipts from VAT came to about 1.9 percent. To trade the latter for the former would have left the regions half a percentage point of GDP worse off, assuming no change in total revenues.¹¹ And in 1996, of the eighty-seven regions for which data were available, only fifteen would have come out ahead, by our count, if their share of VAT had been exchanged for the federal budget's receipts from profit tax collected in that region.¹² On each of these occasions, the main stakeholders in the arrangements that the center wished to reform—the regional governments—were neither coopted with compensatory benefits nor isolated and expropriated effectively. They managed to block reforms that would apparently harm their interests.

The government's draft tax code would also have reduced the number of taxes from about 200 to 32; most of those to be eliminated would have been regional and local taxes.¹³ For this reason, too, regional opposition was intense. Five regions took the matter to the Constitutional Court in 1997, arguing that the federal authorities did not have the right to prevent subnational governments from introducing their own taxes. Though those regions lost their case, the subnational taxes remained.¹⁴

Threatening to dissolve the Duma if it refused, Yeltsin managed to push the Tax Code through the first of three readings in June 1997. But

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(admittedly mostly as the result of increased rates), while corporate-profit tax receipts dropped by 3.6 percent of GDP. As already mentioned, VAT has the advantage that it gives enterprises an incentive to expose their trade partners if they cheat. In addition, the creation of separate agencies to collect federal, regional, and local taxes should increase the discipline and effectiveness of federal tax collectors.

Prohibitively high aggregate tax rates, we have argued, were a result of the governments' incentive to overgraze. With the overlap between different governments' tax bases reduced to a minimum, this incentive would fall. Governments would no longer hesitate to lower taxes to support growth for fear that this would merely create opportunities for other governments to impose higher taxes at their expense. Each level would have an incentive to lower its own taxes, thus reducing the aggregate tax rate.

High tax rates were one of the triggers for the exodus of firms into the unofficial economy. If governments at each level owned the revenues from their own tax bases, and set tax rates and the regulatory burden low enough to maximize revenue, the incentive for businesses to go underground would diminish. This might also lure back some of the business that fled underground as tax rates rocketed.

The assignment of tax power over small businesses exclusively to local governments is also likely to sap the underground economy. Small firms would no longer have to fill out tax declarations to three different levels of government. Regulatory overgrazing of small businesses—the uncoordinated intrusions of inspectors, regulators, and other bureaucrats—would presumably decline as well. And so, therefore, would corruption. With concentrated tax rights and regulatory powers over small business, each mayor would, in Chubais's words, "call in his fire marshal, his chief traffic inspector, and his sanitation inspector, line them up, and find a way to explain to them why a favorable business climate is advantageous to all of them."

These various changes are likely to stimulate economic growth. A lower aggregate tax burden would do so directly. So would a decrease in the burden of regulatory intrusions. At the same time, the likely return of firms from the unofficial to the official economy would mean less waste of resources on secrecy and evasion, freeing up additional resources for investment in production. The alignment of the interests of small businesses and local governments might lead the latter to act like local officials in China, who often extend a "helping hand" rather than a "grabbing hand" to township and village enterprises. The

explosive growth of such enterprises, in which local governments share ownership, has been one of the main sources of China's overall growth since the early 1980s.³

A similar logic would impel regional governments to support the growth of profits in medium and large enterprises. The interest of regional governments in such profits would be more concentrated, since the profit tax would no longer be shared and they would no longer have to fear that the federal government would lower their tax-retention rates if they collected taxes more effectively. At the same time, more effective measures against profit outflow would increase the incentive of regional governments to support regional growth. Instead of transferring its profits to Moscow or Ingushetia, a multidivisional enterprise would pay tax on profit in proportion to its regional workforce or assets. And a per-unit royalty on natural resources would protect regional governments from seeing the region's oil sold at cost to middlemen outside the region to be resold at huge markups. As a result, they would be surer to benefit from further development of resource industries.

Not only would local and regional governments have a concentrated interest in the success of local enterprises, they would have a far stronger interest in increasing their own tax revenues. With secure tax bases and no danger of post-hoc confiscation by higher level governments, local governments would be more motivated to collect the revenues to pay for local public goods such as law enforcement, schools, and medical care that both provide benefits for businesses and please local voters. They would also have the freedom to experiment with different types of tax on small businesses, and the information about which taxes were more successful would spread relatively quickly between the many small localities. In this context, horizontal Tiebout competition between localities to encourage small business could play a growth-promoting role.⁴

What about the effect of the proposed tax reform on barter? Recall that the widespread use of barter in Russia in the 1990s had three separate motivations. It was a means of channeling noninflationary subsidies (via the energy sector) to insolvent enterprises and organizations. It allowed enterprises to circumvent restrictions on selling below cost. And it helped firms to evade federal taxes, since regional and local budgets could accept payments in kind more easily than the federal budget could. Tax reassignment, and in particular the assignment of the profit tax to the regions, would pit firms against the

Conclusion

Chapters 2, 3, and 4 analyzed two aspects of economic reform in Russia that achieved partial successes. The last four chapters have analyzed a failure. No efforts made by the federal government between 1992 and 1998 managed to reverse the decline in tax revenues, to halt the apparent growth of the underground economy, or to stimulate rapid economic growth. The perspective on the politics of reform developed throughout this book helps to explain why.

On several occasions, fiscal reforms with laudable objectives were announced by the federal government, but these reforms lacked a well-designed plan to coopt and expropriate stakeholders in the existing inefficient arrangements. They got nowhere. Key provisions of the 1991 Basic Principles of Taxation Law were never implemented. The government's draft Tax Code, prepared in 1996–97, was gutted in the face of political opposition. Efforts to force companies to pay tax arrears were defeated by enterprises that appealed to supporters in parliament and successfully ran out the clock. A destructive competition between federal and regional governments for the favor of large enterprises weakened both and prompted restrictive policies toward small firms.

In this chapter we have suggested one approach to reform that might stand a better chance of both economic effectiveness and political implementation. The proposal consisted of several measures: tax reassignments to concentrate ownership in particular tax bases, the creation of separate tax-collection agencies for different levels of government, and the division of taxable profits of multiregional enterprises among regions according to the location of work force and assets. We have presented arguments that these measures would improve incentives for governments at all levels to support growth, set moderate tax rates, and collect taxes more effectively. Finally, we have outlined how a strategy of cooptation and expropriation of key stakeholders might be used to overcome the obstructionist coalition of oligarchs and regional governors that impeded the tax reforms that were actually attempted from 1996 to 1998. Although our proposed reforms have a number of drawbacks, they appear to be much more realistic than the brave but ineffective policies pursued by Yeltsin's reformers after the election of 1996.

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Tax Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union

By a Staff Team led by Liam Ebrill and Oleh Havrylyshyn



Issues in Transition

International Monetary Fund
Washington DC
1999

II Recent Revenue Developments

General government revenues, which include revenue from both central and local governments, collected within the Baltics, Russia, and other countries of the former Soviet Union had already fallen below Soviet-era levels by 1993. Revenue as a share of GDP declined on average by the equivalent of about 5 percentage points, from about 35 percent of GDP (weighted average) in 1993 to under 30 percent of GDP in 1995. This reflects a modest increase in the Baltics since 1993, more than offset by a decline in the revenue to GDP ratio of substantially more than 5 percentage points for most CIS countries (Table 1). Thus, for example, the revenue-to-GDP ratio fell by 23 percentage points in Azerbaijan, probably at least 15 percentage points in Tajikistan, and 11 percentage points in Armenia from 1993 to 1996.² In Georgia, while no comparable data are available for earlier years, the 1993 revenue-to-GDP ratio of 3.4 percent, reflecting the civil strife at the time, clearly indicates that there must have been a precipitous drop from the preceding period; thus the rising trend after 1993 is not surprising. To summarize the situation for the CIS countries in the late 1990s, experience ranged from a sizable decline in the revenue-to-GDP ratios—for example, in strife-torn Georgia and Tajikistan, where revenue dropped to 10–12 percent of GDP—to little if any change in places such as Ukraine and Belarus, where economic and structural reforms were less advanced and revenue remained as high as 40–45 percent of GDP.

Figure 1 likewise suggests a relationship between revenue decline and general progress on transition.³ Countries that significantly delayed reforms and retained more of the Soviet-period mechanisms of control over enterprises were generally able to maintain or quickly regain high levels of revenue collection. Belarus, Turkmenistan, and Uzbekistan are clear examples; Ukraine, in which reform began to

move forward only in 1995, is broadly similar, though its revenue did decline more sharply after 1994. Countries that proceeded with reforms and that were not affected by civil strife, such as Kazakhstan, the Kyrgyz Republic, and Russia, all experienced a clear trend reduction in their revenue ratios.⁴ In the Baltics, where reforms came early and advanced rapidly, there was neither a perceptible revenue decline nor indications of revenue levels that were too low for reasonable government operations. These developments suggest that while avoiding economic reforms might have helped maintain revenue close to levels of the Soviet period for some period of time, substantial and sustained progress in reform gave even better results.⁵

The most noteworthy feature as regards the pattern of changes in the major revenue components (Table 2) is the uniform decline in enterprise profits taxation, largely independent of overall revenue developments. This decline reflects, among other things, a combination of falling profitability, growing difficulty in administering profits taxes in economic transition, and the removal of excess wage taxes.

The importance of revenue mobilization has been highlighted by the August 1998 economic crisis in Russia. The crisis had several causes, but a key one was the inadequacy of federal government tax policies in achieving a sustainable improvement in revenue mobilization. The economic downturn in Russia and, looking forward, the contagion effects arising from the crisis are likely to have spillover effects on other CIS countries. This is particularly un-

²The Table 1 values for 1993–94 for Tajikistan are suspect; if, however, one assumes that revenues in the early 1990s were even as low as 27 percent of GDP, that would still imply a decline of at least 15 percentage points.

³See European Bank for Reconstruction and Development (1998) for a comparison of progress in reforms.

⁴Where civil strife occurred, the pattern is mixed, with some countries experiencing a rapid decline very early, even before 1993 in some cases (Azerbaijan, Georgia, Tajikistan), then a substantial recovery from very low levels. Armenia, in contrast, saw the greatest declines after 1994 and only a slight recovery in 1997, while Moldova's pre-1993 decline was followed by a strong recovery as early as 1994.

⁵Note the similarity of this conclusion with that for growth recovery—delaying reforms can minimize the output decline of transition, but the best result comes from strong reforms that lead to early recovery and sustained growth (Havrylyshyn, Izvorski, and van Rooden, 1998).

Table 4. Progress on Tax Policy¹

Country	Assessment of Degree of Policy Reform from 1992 Through Mid-1998
Armenia	2
Azerbaijan	3
Belarus	4
Estonia	1
Georgia	2
Kazakhstan	2
Kyrgyz Republic	3
Latvia	1
Lithuania	1
Moldova	2
Russia ²	4
Tajikistan	3
Turkmenistan	5
Ukraine	3
Uzbekistan	4

Source: IMF staff estimates.

¹Scale from 1 (high degree of appropriate market-oriented reform) to 5 (very little, if any, reform).

²Tajikistan subsequently adopted a new tax code that would move its score to 1.

portant, this is a snapshot of a rapidly moving picture. Some countries—for example, Tajikistan—have made further significant progress since mid-1998. Others have experienced some policy reversals—for example, Georgia—which illustrates how difficult maintaining good policy is. Finally, these rankings refer only to de jure tax policy, as embodied in the written laws and subsidiary regulations, and not necessarily as actually implemented by the tax administrations in each case.

One might expect progress in tax reform to be significantly correlated with revenue performance in the various countries. However, much of the reform has occurred only over the past 12 to 18 months, far too recently for effects to be seen. Further, many appropriate tax policy changes do not translate into higher tax revenues in the short run; in fact the contrary may be true for certain areas where it appears that some of the greatest progress has been made (e.g., elimination of excess wage taxes and export taxes).

Tax Administration

In general, progress in tax administration reform in CIS countries has been slow for several reasons. First, tax administration continues to be a highly politicized function of government, where tax liabilities are largely negotiable instead of being deter-

mined by law. Efforts to determine tax liabilities based on the law are greatly complicated by the constant changes and uncertainty of many countries' tax legislation and related laws (e.g., civil code and bankruptcy laws). Moreover, in many of the CIS countries, the tax administration is not equipped to handle the significant increase in the number of taxpayers and the different types of taxpayers, particularly small- and medium-sized taxpayers in the private sector, which have emerged in the course of the economic transformation. In addition, the pervasiveness of barter trade, noncash transactions, and the use of monetary and tax offsets to pay taxes has complicated the tax administrations' task of collecting taxes in cash from important segments of the taxpaying population. Finally, in many countries, political commitment at the highest levels of government to fundamental tax administration reform has been lacking, and the instability in the tenure of the tax administration's senior management has also impeded the effective implementation of reforms.¹⁴

The experience of other countries demonstrates that reforming the tax administration's organization, systems, and procedures is neither simple nor quick. Tax administration reform usually involves many issues (see Appendix II, Table A8) and takes time and resources to implement effectively. In that connection, the IMF has been extensively involved in providing technical assistance on tax administration issues in only a subset of the CIS countries—Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Russia, and Ukraine.¹⁵ Against this background, this section summarizes recent progress in the implementation of administration reforms and reviews the current status of tax administration reforms.

Initiatives Taken During 1997/98

Reforms have focused on (1) enactment of tax administration legislation consistent with the shift to market-oriented economies; (2) management and organizational reforms, including the establishment of a large taxpayers unit;¹⁶ (3) development of systems

¹⁴A number of previous papers have analyzed the special problems of reform of tax administration in transition economies. For additional background, see Casanegra de Jantscher, Silvani, and Vehorn (1992), Silvani and others (1996), Silvani and Brondolo (1996), and Silvani and Baer (1997).

¹⁵Because of this, a thorough assessment of the most recent experience in implementing reforms has been limited to five countries: Azerbaijan, Georgia, Kazakhstan, Russia, and Ukraine.

¹⁶A large taxpayer unit is a division of a tax administration that ideally is responsible for all aspects of audit, collection, and enforcement from taxpayers representing tax revenues over a certain threshold level. Relatively few such taxpayers are typically the source of a large fraction of total revenues. Experience has shown that such units can effectively increase compliance by the major taxpayers.

EXHIBIT 33

Problems of Economic Transition

A JOURNAL OF TRANSLATIONS
FROM RUSSIAN

APRIL 2000

Perspectives and Prognosis
on Russia's Future

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M.E. Sharpe

impediments to entrepreneurial activity today. Obviously, without clear guarantees of the preservation of ownership control of their companies in the long run, the largest shareholders will be oriented toward extracting short-term gains. This also logically assumes the nonpayment of taxes in various forms (insofar as the advantages of law-abiding legal behavior are known only in the long run) and the "sucking" of financial resources out of the enterprises under their control. All of this goes entirely for investments as well. Under such conditions, at best, the largest shareholders will invest in short-term "high-impact" projects, which inevitably limits the opportunities for the restructuring of enterprises and the potential for economic growth.

From this standpoint, measures aimed at *the disclosure of information on joint-stock companies*, the regulation of dealings with *affiliated individuals*, *the protection of the rights of shareholders*, and the like are very important. No less important is the improvement of *bankruptcy procedures*—with the elimination of the current opportunities for an outside manager, as a rule acting in the interests of one or a group of major creditors, objectively to facilitate the sell-off of a bankrupt enterprise rather than its restructuring. It is also essential that the process of replacing the owner in conflict situations always occurs in the context of open judicial proceedings.

The level of *accumulated overdue indebtedness* on taxes is the main factor in the negative motivation of firms in the real sector. In a certain sense, a dead-end situation or "institutional trap" is arising here. Under conditions of mass nonpayments of taxes, the state is obviously unable to bankrupt all debtors to the budget. As a result, the "administrative obligations" of the state to fulfill the laws in practice are not being met, although against the backdrop of occasionally heard resounding government declarations, for each individual enterprise today, there is a likelihood that the application of bankruptcy procedures is preserved and even increases, at least to scare the rest.

In this regard, experience shows that the choice of specific enterprises to carry out such "show trials" depends exclusively on the will of specific bureaucrats. As a result, the direct positive impact of such measures on the budget proves to be exceedingly insignificant. At the same time, such actions undertaken in the name of the government as a whole merely increase the risk of arbitrary ownership redistribution, thereby providing additional incentives for the export of capital from Russia, because the payment of all the accumulated debt is unrealistic

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EXHIBIT 34

IMF Working Paper

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Fiscal Affairs Department

Evaluation of Taxes and Revenues from the Energy Sector in the Baltics, Russia, and Other Former Soviet Union Countries

Prepared by Dale F. Gray¹

Authorized for distribution by Liam P. Ebrill

March 1998

Abstract

This paper examines the level and structure of fiscal revenues from the Baltics, Russia, and other former Soviet Union countries' (BRO) energy sector and suggests reforms in energy tax policy. Revenues from the oil and gas sectors are about half the level that might be expected from international comparisons. Low oil revenues result from infrastructure constraints on oil exports, weak tax administration, and inappropriate tax structures. Low gas revenues are due to low statutory tax rates, a tax structure that does not capture monopoly or resource rents, and weak tax administration. Taxation of oil products could be increased.

JEL Classification Numbers: H2, L1, L5, L71, L95, P2

Keywords: tax policy, petroleum, natural resources, regulation, energy, natural monopoly

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APPENDIX II. RUSSIA ENERGY SECTOR: NONPAYMENT AND TAX EVASION IN THE ENERGY SECTOR

What are the causes and special features of nonpayment in the energy sector, particularly nonpayment for gas, electricity, and fuel oil? Data show that in 1996 about 20 to 30 percent of energy bills were paid in cash, 20 to 30 percent were registered as arrears, and the remaining 50 percent were settled through barter, promissory notes, and debt for equity exchanges.⁵³ There are several reasons for this pattern:

- Energy prices are frequently much higher to industry than short-run or long-run economic cost of supply, even with excess supply. This has exacerbated the energy debt problem for consumers. Thus, poor regulation of utility prices leads to high prices that contribute to high debts and nonpayment.
- Energy companies accept noncash payment for energy supply because:
 - (a) The opportunity to sell incremental gas or electricity elsewhere, if not sold to current customers, is low. This is because of the massive surplus of gas and electricity in most parts of Russia, due to declining demand, and to export and transmission constraints.
 - (b) The high prices charged to industrial consumers allow the energy companies to discriminate between various customers.⁵⁴ This includes allowing the buildup of arrears which are then settled with noncash transactions.
 - (c) Benefits of noncash payments are frequently high. Promissory notes and brokered multilateral barter are a means of concealing revenues and evading taxes. Such arrangements benefit the energy company and individuals involved in the transactions. Large energy companies, in particular, may be able to receive favorable terms for noncash payment as they have the ability to cut off or reduce supply to many customers. The marginal benefit earned from these noncash transactions need only cover marginal cost. The marginal cost of supplying energy is relatively low, near operating cost for an industry facing declining demand. In some cases, the energy company has been able to acquire equity in consuming enterprises very cheaply by swapping energy debts for equity.
 - (d) The government, in some cases, discourages cutoff of energy supply to various industries. The consuming industries act to avoid hard budget constraints, and in some cases can mobilize enough government support to prevent cutoff of supply.

⁵³Brunswick Brokerage, 1996.

⁵⁴Bagratian and Gorgen, 1997.